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In the Supreme Court of the United States

OCTOBER TERM 1944

No. 1070 47

TALBOT MILLS,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

TO THE HONORABLE THE JUDGES OF THE SUPREME COURT OF THE UNITED STATES:

Talbot Mills, a Massachusetts corporation, prays that a writ of certiorari issue to review the decision of the Circuit Court of Appeals for the First Circuit, entered in the above case on December 22, 1944, affirming a decision of the Tax Court of the United States entered February 12, 1944.

STATEMENT OF THE MATTER INVOLVED

The Respondent determined a deficiency in Petitioner's Income and Excess Profits Tax liability for the Petitioner's taxable (fiscal) year ended September 30, 1940 (R. 57–59). Petitioner applied to the Tax Court of the United States for a redetermination of the deficiency (R. 3–6). The Tax Court sustained the Respondent's determination of a deficiency

(R. 73–81, 85). Petitioner duly sought review by the United States Circuit Court of Appeals for the First Circuit (R. 86–7). The Circuit Court of Appeals, one judge dissenting, affirmed the decision of the Tax Court (R. 93–106).

The deficiency was based upon the disallowance by the Respondent of $40,000 which the Petitioner had deducted as interest upon its return (R. 59, 73, 93–94). This was interest on the Petitioner's issue of registered notes, outstanding in the aggregate face value of $400,000 (R. 74, 95). A specimen of these notes appears in the record (R. 19–25). It was stipulated that the item of $40,000 was properly accrued for and on account of the taxable year in question (R. 14–15). The issue was whether such item, so accrued, constituted interest deductible within the meaning of Section 23 (b) of the Internal Revenue Code (R. 59, 3–6, 14–15, 73, 78, 97).

The central and dominant feature of Petitioner's notes was an unqualified promise to pay to each payee a fixed sum of dollars at a definite maturity, slightly over twenty-five (25) years after the date of issue (R. 19, 74, 95). The Petitioner further promised to pay to each payee, as interest upon such fixed amount of principal, not less than 2 per cent (2%) nor more than ten per cent, (10%) in each year, within which range the actual rate in each year was to be determined by a formula having reference to the Petitioner's earnings for such year (R. 20, 75, 95). Interest for the year ended September 30, 1940, was determined at the rate of 10 per cent. in accordance with these provisions (R. 48, 78, 96–97) being the $40,000 the deduction whereof is in question (R. 78, 93).

Nowhere in the Commissioner's pleadings or in the findings of the Tax Court or in the opinion of the Circuit Court of Appeals can be found any suggestion that the promises embodied in the Petitioner's notes were not genuine, made in good faith, and intended to be performed in accordance with their terms. There was no suggestion that the notes were a "sham," or that they did not embody the real understanding of the parties to the transaction.[1]

[1] See specifically the dissenting opinion (R. 103)

Nevertheless, the Tax Court held that the notes did not create any "proper indebtedness," that they "were more in the nature of a capital investment than a loan to the corporation," and that the payments made as interest were not deductible under Section 23 (b) of the Internal Revenue Code (R. 81).

The Tax Court based its conclusion upon the circumstances: (a) that the notes bore a "variable rate of interest computed with reference to profits" (R. 79); (b) that they were "issued in exchange for stock of the issuing corporation" (R. 79, 80); (c) that the notes provided under certain circumstances that "the payment of interest might be deferred" (R. 79); and (d) that the "factor of tax avoidance" was a "substantial purpose motivating the transaction" (R. 80). It asserted that the "cumulation of these various restrictive features . . . tends to cast doubt on the real nature of the instant transaction" (R. 80); that therefore the intent of the parties must be sought, with evidence *aliunde* the contract admissible (R. 80); and that "what the parties really intended to create was a security retaining the profit-sharing advantage of stock, leaving intact their voice in the management,[2] but extending a tax advantage to the corporation not possible in stock" (R. 80–81).

The Circuit Court of Appeals based its decision upon the circumstances that the notes were issued in exchange for stock (R. 98, 101); that the rate of interest was variable (R. 99–100); that the notes were capable of being subordinated to the claims of other creditors (R. 101); that the payment of interest could be deferred (R. 100); and that Petitioner had tax avoidance as a motive in the issuance of notes in exchange for stock (R. 98–99). It also held that the meaning of the notes was governed by extrinsic evidence (R. 98, 99). In addition, the Court relied upon *Dobson* v. *Commissioner*, 320 U. S. 489 (1943) as requiring that the Tax Court be upheld.

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[2] Ignoring the obvious fact that this right was attached only to the stock, not to the notes.

Both the Tax Court and the Circuit Court of Appeals also apparently regarded as material the facts that the Petitioner had but few stockholders, who were related by blood or marriage; that the noteholders also continued to hold stock; and that but few of the notes had been transferred to date (R. 74, 76, 80, 94, 98, 99).

The Tax Court and the Circuit Court of Appeals both ignored the strong categorical language of I.R.C. Section 23 (b) providing that deduction shall be allowed for *"all interest* paid or accrued within the taxable year on indebtedness" (italics added). Both paid as little regard as possible to the fundamental fact that the notes embodied a firm promise to pay a fixed sum of money at a fixed maturity, which, at least for every purpose other than taxation, would unquestionably constitute an indebtedness. Both concerned themselves with "tax motives." The tenor of both decisions is made sharply clear by the contrast presented by the dissenting opinion of Judge Magruder (R. 101).

The Petitioner submits that the decision of the Circuit Court should be reviewed by this Court upon certiorari, for the reasons stated below, in support whereof a brief is filed herewith.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT

Under the principles enunciated in Section 5 (b) of Rule 38 of this Court, the Petitioner submits that the writ should be granted for the following reasons:

1. The decision is in substance in conflict with the decision of the Circuit Court of Appeals for the Second Circuit in *Commissioner* v. *O.P.P. Holding Corporation,* 76 F. 2d 11 (C.C.A. 2nd, 1935).

2. The Circuit Court of Appeals has decided federal questions in a way probably in conflict with applicable decisions of this Court in at least the following respects:

(a) With respect to the meaning of "interest" as used

in the tax statutes—*Deputy* v. *Dupont*, 308 U. S. 488, 84 L. Ed. 416 (1940).

(b) With respect to the propriety of stipulating for a variable rate of interest computed with reference to profits—*Meehan* v. *Valentine*, 145 U. S. 611, 36 L. Ed. 835 (1892).

(c) With respect to proper principles of construction, giving to words in the tax statutes their plain and natural meaning—*Deputy* v. *Dupont*, *Supra*.

(d) With respect to the construction of tax statutes in favor of taxpayers in proper cases—*Gould* v. *Gould*, 245 U. S. 151, 62 L. Ed. 211 (1917).

(e) With respect to when "evidence *aliunde* the contract" may be used to control the meaning of a written instrument—*Hamilton* v. *Liverpool, etc. Ins. Co.* 136 U. S. 232, 34 L. Ed. 419 (1890).

(f) With respect to the right of taxpayers to arrange their affairs with an eye to tax consequences—*Bullen* v. *Wisconsin*, 240 U. S. 625, 60 L. Ed. 830 (1916).

(g) With respect to a proper regard to the actual language used by Congress and to refraining from judicial legislation—*Crooks* v. *Harrelson*, 282 U. S. 55, 75 L. Ed. 156 (1930); *Iselin* v. *United States*, 270 U. S. 245, 70 L. Ed. 566 (1926).

(h) With respect to the application of the rule making decisions of the Tax Court final in respect of matters of fact but not in respect of matters of law—*Dobson* v. *Commissioner*, 320 U. S. 489; 88 L. Ed. 179 (1943).

3. The Circuit Court of Appeals has decided important questions of federal law which have not been, but should be, settled by this Court because of,

(a) Their importance in the administration of the tax laws;

(b) Their importance to citizens of the Country about their commercial affairs;

(c) Their importance with respect to permissible judicial methods.

Each of the grounds mentioned above will be expanded and supported in the Petitioner's brief.

Wherefore, your Petitioner respectfully prays that a writ of certiorari be issued to the United States Circuit Court of Appeals for the First Circuit for a review of the decision of the Circuit Court of Appeals and that the judgment of the Circuit Court of Appeals be reversed and that the Petitioner be granted such other and further relief as may be proper.

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In the Supreme Court of the United States

OCTOBER TERM 1944

No.

TALBOT MILLS,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

Talbot Mills, a Massachusetts corporation, respectfully submits this brief in support of its petition for a writ of certiorari, printed and filed herewith.

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 93) is reported in F. 2d . The opinion of the Tax Court (R. 73-81) does not appear yet to be officia ly reported, the presently available reference being 3 T.C. , No. 11. An unofficial report may be found in the CCH Tax Court Service, Volume 2, Dec. 13,691.

JURISDICTION

A. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925 (U. S. Code, Title 28, Section 347 (a)).

B. The case involves the construction and application of Internal Revenue Code, Section 23 (b), providing that in computing net income there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebt-

edness (with an exception not material). This deduction has been denied to the Petitioner in violation of applicable principles of law, as hereinafter set forth. That the issues are substantial appears well confirmed by the dissenting opinion in the Circuit Court of Appeals and by the matters presented hereinafter in this brief.

C. The decision of the Circuit Court of Appeals was entered December 22, 1944. This petition, in accordance with the requirements of the Act of February 13, 1925 (U. S. Code, Title 28, Section 350) will be filed within three months after the above-mentioned date.

STATEMENT OF THE CASE

The "Statement of the Matter Involved," found at pages 1-4 of the Petition, *supra,* contains in summary form the facts material to the consideration of the questions presented, with references to the pages of the record. For the sake of brevity, we do not repeat this material here but respectfully incorporate it by reference.

The pertinent provisions of the petitioner's notes, with references to the full text as it appears at pages 19-23 of the printed record, are as follows:

(a) The unqualified promise to pay a fixed sum in dollars at maturity on December 1, 1964 (R. 19).

(b) The agreement to pay interest at not less than 2% and not more than 10%, and, within that range at the rate (to the nearest ¼%) which a sum equal to two-thirds (⅔) of the Petitioner's net earnings for the fiscal year would represent upon an assumed principal of $400,000 (R. 20).

(c) The agreement to pay interest under certain circumstances at the flat rate of 6% (R. 20, 21, 22).

(d) The power of the Petitioner to defer payment of interest, only as the Directors in good faith determine to be necessary, and in no event beyond December 1, 1964 (R. 20).

(e) Acceleration of maturity in event of bankruptcy and the like (R. 21).

(f) The power of the Petitioner to effect subordinations to other obligations maturing not later than December 1, 1964. Note that there was no general subordination, only a power to make (and, under proper conditions, terminate) subordinations (R. 21-22).

(g) The power to call and retire the notes (R. 22-23).

(h) The power of three-fifths (3/5) of the noteholders to consent to changes, not affecting the fundamental obligations (R. 23-24).

(i) Provisions affecting transferability (R. 24).

The recapitalization, in the course of which the notes were issued, is set out in the record (R. 10-13; 18-19; 26-28; 36-39; 41-45).

Certain specific subordinations, since terminated, are set out in the record (R. 14; 29-35; 44-45; 46-47;).

The statute under which the deduction is claimed is as follows:

INTERNAL REVENUE CODE

Sec. 23. DEDUCTIONS FROM GROSS INCOME

In computing net income there shall be allowed as deductions:

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except . . ." (Exception not material)

SPECIFICATION OF ERRORS

The Petitioner specifies, and will urge upon the granting of the writ, the following errors committed by the Circuit Court of Appeals.

1. The Court erred in holding that the sums accrued as interest upon the Petitioner's outstanding registered notes were not deductible as interest under Internal Revenue Code, Section 23 (b).

2. The Court erred in applying a rule which makes only some interest upon some indebtedness deductible, whereas the statute grants a deduction to *all* interest upon indebtedness.

3. The Court erred in failing to construe the term "interest" in said statute as including the amounts accrued upon the Petitioner's registered notes.

4. The Court erred in failing to attribute to the terms "interest" and "indebtedness" in said statute their plain and natural meaning as reflected in common usage and general law.

5. The Court erred in failing to construe the term "indebtedness" in the statute as including the principal obligation created by the Petitioner's registered notes.

6. The Court erred in construing the statute by the application of an untenable distinction between "loans" and "capital investments."

7. The Court erred in using extrinsic evidence to control the meaning of Petitioner's notes.

8. The Court erred in applying criteria, applicable only in cases of alleged sham and the like, to a case in which there was in fact no question and no issue but that the Petitioner's notes were genuine and intended to be enforced according to their terms.

9. The Court erred in holding in effect that interest, to be deductible under the statute, must not be at a rate measured with reference to profits.

10. The Court erred in regarding and making the basis of its decision such factors as:

(a) That the Petitioner's notes were issued in exchange for stock;

(b) That the Petitioner's notes provided for a variable rate of interest;

(c) That the Petitioner's notes brought no new capital into the corporation;

(d) That the Petitioner's notes were capable of being subordinated to claims of other creditors;

(e) That under the provisions of Petitioner's notes payments of interest might be deferred;

(f) That Petitioner's notes were held by persons who were also stockholders;

(g) That the holders of Petitioner's notes were related by blood or marriage.

11. The Court erred in regarding and making the basis of its decision, the circumstance that a tax advantage was a principal purpose of the recapitalization in which Petitioner's notes were issued.

12. The Court erred in treating the indebtedness actually created by the Petitioner's notes as if it were "form" instead of "substance" in a case in which there was neither evidence nor suggestion of sham or unreality, or of a temporary expedient (Cf. *Gregory* v. *Helvering*, 293 U. S. 465), or of a transaction for security only or to achieve some other unrelated end (Cf. *Wiggin Terminals* v. *United States*, 36 F. 2d 893; *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. 2d 833).

13. The Court erred in failing to apply the rule of construing tax statutes in favor of the taxpayer, in a case where the application of such rule merely required giving to the language of the statute its plain, straightforward meaning.

14. The Court erred in applying the rule of *Dobson* v. *Commissioner*, 320 U. S. 489, in a case in which the fundamental issues involved were issues of law and not of fact.

SUMMARY OF ARGUMENT

It is respectfully submitted that this Court should consent to review this case because of its importance in the administration of the revenue laws, its importance with respect to past, present and future dealings of business organizations throughout the Country with respect to their financial arrangements, and finally its importance with respect to the judicial process itself.

The decision of the Circuit Court of Appeals for the First Circuit is in essence incompatible with the leading case upon a like subject matter in the Second Circuit.

In reaching its decision, the Circuit Court of Appeals of necessity violates clear principles set out in the decisions of this Court with respect to the construction and interpretation of statutes; the meanings of the terms "interest" and "indebtedness"; the duty of courts not to vary the clear meaning of a genuine unambiguous written instrument by recourse to so-called "evidence *aliunde* the contract"; the right of citizens to arrange their affairs with a view to the minimum incidence of taxation; the duty of the courts to refrain from "judicial legislation"; and the reviewability of decisions of the Tax Court upon issues of law.

The Petitioner protests against a judicial technique which, with the almost palpable objective of defeating the Petitioner's purpose to minimize the incidence of taxation, disregards the express language of the statute, treats a genuine business arrangement as if it were a sham although no issue of sham exists, disregards applicable rules for the construction of statutes, in effect asserts the existence of a common law of taxation with a right to control and alter the statutes enacted by Congress, discriminates against the Petitioner because it is owned by a few people instead of by many, and in general deprives it and all others similarly situated of their clear rights under the law. That the Petitioner is aggrieved, may by itself be no basis for the issuance of the writ. But the interests imparied by the establishment of any grossly erroneous judicial technique are the interests of the whole people.

ARGUMENT

I. THE DECISION OF THE CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT IS IN CONFLICT WITH *Commissioner* v. *O.P.P. Holding Corporation*, 76 F. 2d 11, DECIDED IN 1935 BY THE CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

In the case mentioned above, the debenture bonds in question obligated the corporation to pay fixed sums of money at a definite maturity date. The interest thereon was held to be deductible in spite of the facts that (a) two-thirds of the outstanding bonds might extend the maturity date for all;

(b) the bonds were subordinated to the claims of general creditors; and (c) the Company might at its option suspend or defer the payment of interest provided it was not relieved of "the obligation to pay the same at some future time." It was held that the interest upon these bonds was deductible and the emphasis of the Court was correctly placed, at p. 12, upon the central fact that the creditor was entitled to be paid eventually from the debtor's property, regardless of whether there should be a surplus.

In the present case, the Tax Court and the Circuit Court of Appeals have ignored this central feature, which is the dominant characteristic of an indebtedness, and have placed their emphasis upon subordinate features, every one of which is a proper incident of an indebtedness and, based upon these subordinate features, have arrived at the conclusion that there was no "proper" indebtedness.

Distinctions drawn between the two cases, merely because exactly the same set of subordinate features was not present in both cases,[1] cannot properly account for the difference in the results. Further, any attempt to rest the distinction solely upon the fact that the present Petitioner's notes contained a variable rate of interest would be unsound under decisions of this Court (see pp. 14-15, *infra*).

II. THE DECISION OF THE CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT IS IN PROBABLE CONFLICT WITH NUMEROUS DECISIONS OF THIS COURT.

A. *The meaning of "interest on indebtedness"—Herein of the variable rate of interest.*

[1] For example the *O.P.P. Holding Company* case did not contain the element of a variable rate of interest or the element of notes having been issued in exchange for stock. On the other hand, the Talbot Mills notes did not authorize two-thirds of the bonds to extend the maturity date and did not provide an absolute subordination to the claims of other creditors but only an authority to vote and terminate specific subordinations.

In *Deputy* v. *Dupont*, 308 U. S. 488, 84 L. Ed. 416 (1940), this Court said:

> "In the business world, 'interest on indebtedness' means compensation for the use or forbearance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense. In sum, we cannot sacrifice the 'plain, obvious and rational meaning' of the statute even for 'the exigency of a hard case.'" 308 U. S. p. 498; 84 L. Ed. p. 424.

The carefully selected words "compensation for the use or forbearance of money" definitely exclude from consideration the question whether the debt was incurred as the purchase price of the debtor's own stock. Obviously there is "forbearance of money" so long as the creditor, voluntarily or in accordance with his written contract, forbears to receive from the debtor the sum owned. And a sum may become owing for any valuable consideration. Manifestly the surrender of the Petitioner's stock in the present case was such a valuable consideration.[2]

In *Meehan* v. *Valentine*, 145 U. S. 611, 36 L. Ed. 835, this Court said, as follows:

> "In whatever form the rule is expressed, it is universally held that an agent or servant, whose compensation is measured by certain proportion of the profits of the partnership business, is not thereby made a partner, in any sense. So an agreement that the lessor of a hotel shall receive a certain portion of the profits thereof by way of rent does not make him a partner with the lessee. . . . And it is now equally well settled that the receiving of part of the profits of a commercial partnership, in lieu of or in addition to interest, by way of compensation for a loan of money, has of itself no greater effect." 145 U. S. p. 624; 36 L. Ed. p. 841.

It seems perfectly clear that it is a legitimate, and may be a wise, arrangement for a creditor to make with a debtor that the rate of pay which he is to receive for his forbearance of

[2] See dissenting opinion of Magruder, J. (R. 102).

money be related to the success of the debtor during the term of forbearance. And if such an arrangement with a partnership, which is not a separate legal entity, does not make the creditor a partner, *a fortiori* such an arrangement with a corporation, which is a legal entity, can hardly of its own force render the creditor a stockholder.[3] Even the Tax Court itself has held that interest may properly be measured in relationship to the debtor's earnings. See *Kena, Inc.*, 44 B.T.A. 217.

It follows that it was not proper for the Court below to rest its decision upon the feature of the variable rate of interest. Nor would it be according due regard to the decisions of this Court to say that this feature, in combination with other features, every one of which are common permissible arrangements in connection with an indebtedness, turns a creditor into a stockholder when each feature by itself has no lawful tendency to do so.

B. *Rules for the construction of statutes—Ordinary meaning of terms—Construction in taxpayer's favor.*

In *Deputy* v. *Du Pont, supra,* this Court said,[4]

> "And when it comes to construction of the statutory provision under which the deduction is sought, the general rule that 'popular or received import of words furnishes the general rule for the interpretation of public laws,' . . . is applicable." 308 U. S. p. 493; 84 L. Ed. p. 421.

Thereupon, as an illustration of this principle, the Court offered the definition of interest quoted above (see p. 14, *Supra*).

Internal Revenue Code, Section 23 (b), in the strongest possible terms, grants a deduction for "all interest . . . on indebtedness." One may well ask how Congress could have made the language stronger—unless, indeed, it is to be held the duty of the legislative, when trying to attain inclusive-

[3] See dissenting opinion of Magruder, J. (R. 101–2, 104).

[4] Accord, *Old Colony Railroad Co.* v. *Commissioner,* 284 U. S. 552, 560, 76 L. Ed. 484, 489 (1932).

ness, to clutter up the statutes with such expressions as "of all kinds, manners and descriptions whatsoever."

It is so obvious as to need no argument, and indeed to be almost incapable of argument, that in common parlance as well as general law the Petitioner's notes, with their central unqualified obligation to pay a fixed sum at a fixed maturity, were the written evidences of an indebtedness. And, if they were, it necessarily follows that the amount paid to service the debt was interest, however fragile, qualified or complicated the interest terms might be. Interest is no necessary feature of an indebtedness. There are debts which do not bear interest. And, if that is so, then, given a debt, it follows that any not unlawful stipulation with respect to the compensation to be paid for forbearance of the debt is interest. It is impossible to arrive at the result reached by the Tax Court and the Circuit Court of Appeals without coming in conflict with *Deputy* v. *Dupont, supra.*

In *Gould* v. *Gould,* 245 U. S. 151, 62 L. Ed. 211 (1917), this Court said,

> "In case of doubt," tax statutes "are construed most strongly against the government, and in favor of the citizen." 245 U. S. p. 153; 62 L. Ed. p. 213.

This rule is thoroughly capable of being reconciled with the rule of "strict construction" of exemptions, credits, deductions and the like, found in such cases as *Woolford Realty Co.* v. *Rose,* 286 U. S. 319, 76 L. Ed. 1128 (1932).

Careful examination of cases of the latter sort [5] will show

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[5] *New Colonial Ice Co.* v. *Helvering,* 292 U. S. 435, 78 L. Ed. 1348 (1934)
White v. *United States,* 305 U. S. 281, 83 L. Ed. 172 (1938)
Deputy v. *DuPont,* 308 U. S. 488, 84 L. Ed. 416 (1940)
Helvering v. *Northwest Steel Rolling Mills,* 311 U. S. 45, 85 L. Ed. 29 (1940)
Helvering v. *Ohio Leather Co.,* 317 U. S. 102, 87 L. Ed. 113 (1942)
Equitable Life Assurance Society v. *Commissioner,* U. S. , 88 L. Ed. 603 (1944)

that they have never expressly overruled the decisions for construction in the taxpayer's favor, that they have never used the "strict construction" rule to deprive a taxpayer of the benefit of plain, fair, ordinary meaning of a provision establishing a deduction, and that the rule of strict construction has only been used to deny claims for the extension or expansion, by implication, of deduction sections, or to refute arguments which would have precluded the Court from exercising its proper judicial function in the resolving of genuine questions of construction.

It takes little more than lip service to the principle enunciated in *Gould* v. *Gould* to reach the conclusion in the present case that a statute providing for the deduction of *all* interest on indebtedness may not by judicial construction be cut down into a deduction of some types of interest on some indebtedness. Unless and until the principle of *Gould* v. *Gould* is expressly overruled by this Court, the decision below stands in inescapable conflict with it.

C. The use of "evidence aliunde the contract."

In *Hamilton* v. *Liverpool, etc. Ins. Co.*, 136 U. S. 242, 34 L. Ed. 419 (1890), this Court said that construction of the correspondence in writing between the parties presented a pure question of law to be decided by the Court.[6] In the present case, there is a complete and integrated document

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[6] The general proposition here adduced may be viewed as an important question of general law and not merely as involving a federal question by reason of being raised in this case in conjunction with the application of a federal statute.—See in further support of the principle,

Commissioner v. *Coastwise Transportation Corp.*, 71 F. 2d 104, 105, (C.C.A. 1st, 1934)

Brown v. *J. C. Shaffer Grain Co.*, 15 F. 2d 514 (C.C.A. 1st, 1926)

S. S. Kresge Co. v. *Sears*, 87 F. 2d 135, 138, 140 (C.C.A. 1st, 1936)

Union State Bank & Tr. Co. v. *Northwestern Life Ins. Co.*, 55 F. 2d 1070, 1072 (C.C.A. 5th, 1932)

of the sort with respect to which loose ends are never intentionally left and which, by virtue of intended transferability, is the least subject to be controlled by extrinsic evidence.

The Court below, in the course of reaching a particular tax result, has talked about "consideration of the relevant facts," about looking to "actualities of the situation," about looking to see whether interest may be regarded as the "further distribution of profits" and about "exalting form above substance." We freely concede that if there had been precipitated an issue with respect to whether the notes were not genuine but a sham (or any other like issue involving the unreality of appearances),[7] all such language might have been relevant, but we also submit that upon this record there is neither any evidence upon which such an issue could have been based nor any indication of the purpose of the government to raise such an issue.[8]

It was therefore completely erroneous for the Tax Court and the Circuit Court of Appeals to hold themselves entitled to consider such facts as that the Petitioner was owned by a few stockholders (R. 74, 80, 94, 98), or that the stockholders were relatives (R. 74, 80, 94, 98), or that the noteholders acquired their notes through giving up

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S. H. Kress Co. v. *Fisher*, 65 F. 2d 682, 683 (C.C.A. 4th, 1933)

Merinos Viesca Y Compania v. *Pan American P & T Co.*, 55 F. 2d 1070, 1072 (C.C.A. 5th, 1932)

National Surety Corp v. *Ellison*, 88 F. 2d 399, 403 (C.C.A. 8th, 1937)

[7] An example of such a case is *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. 2d 833 (C.C.A. 7th, 1927). To such a case the language in *Commissioner* v. *Proctor Shop, Inc.*, 82 F. 2d 792, 794 (C.C.A. 9th, 1936) would properly be applicable; but the use made of that language by the Tax Court in the present case (R. 80) and by the Circuit Court of Appeals (R. 99) is utterly unwarranted because of the fundamental difference between the situations presented.

[8] See dissenting opinion of Magruder, J. (R. 103).

stock (R. 79, 80, 98), or that the holders of the notes also continued to hold their remaining stock (R. 80, 98), or that a small amount rather than a large amount ever changed hands (R. 80, 96, 99), and upon the basis of such considerations arrive at the conclusion that for purposes of taxation the notes were not the evidences of indebtedness which for every other purpose in general law and ordinary business life they were.

D. *As to the right of the Petitioner to rearrange its affairs with frank regard to minimizing the incidence of taxation.*

In *Bullen* v. *Wisconsin*, 240 U. S. 625, 60 L. Ed. 830 (1916), this Court said,

> "We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as an evasion, what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law." 240 U. S. p. 630–631, 60 L. Ed. p. 835.

The concern of the Tax Court and of the Circuit Court of Appeals with the Petitioner's so-called "tax motives" was improper under the language quoted above and, in effect if not in form, was a flat denial of the Petitioner's right to deduct the interest on notes outstanding if such notes were issued with tax objectives in mind.

Counsel have relied upon the famous words of Mr. Justice Holmes for many years. Constantly they have advised clients that they might so rearrange their affairs as to present the least exposure to taxation under the laws, provided only that in so doing their arrangements were genuine and durable and not false fronts for other underlying arrangements at variance or temporary devices like the scaffolding that surrounds a building (Cf. *Gregory* v. *Helvering*, 293 U. S. 465). The citizens of this Country are entitled to know from this Court whether that principle still prevails in its former integrity.

It is manifest that if the circumstance of "tax motives"

may be utilized by the courts in the manner in which it was utilized in the opinions below, the words of *Bullen* v. *Wisconsin* become simply a trap for the unwary.

We recognize what is said about the "policy, if not . . . the mere letter of the law." But the policy of a federal tax statute is to be found in the statute itself, possibly illuminated by its history, and not in the policy-making tendencies of judges. It is notable that in the decisions below there was not made even the faintest attempt to interpret the words of I.R.C. Section 23 (b) in the light of context or of other portions of the statute or of previous enactments or of legislative history.[9] Instead the words were ignored and the policy was summoned into existence out of the judicial imagination.

In this latter respect, the courts below have flown in the face of the admonitions against judicial legislation found in decisions of this Court and of the Circuit Courts of Appeals as well:

Crooks v. *Harrelson*, 282 U. S. 55 (1930), 75 L. Ed. 156, 175

Iselin v. *United States*, 270 U. S. 245, 251 (1926) 70 L. Ed. 566, 69-70

Western & Southern Life Ins. Co. v. *Huwe*, 116 F. 2d 1008, 1010 (C.C.A. 6th, 1941)

Forstman v. *Rogers*, 128 F. 2d 126, 129 (C.C.A. 3d, 1942)

Noteman v. *Welch*, 108 F. 2d 206, 208, 215 (C.C.A. 1st, 1939)

Mead Corporation v. *Commissioner*, 116 F. 2d 187, 191 (C.C.A. 3d, 1940).

E. *The inapplicability of Dobson* v. *Commissioner.*

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[9] We are prepared to show that the history of the statute imparts to the words "all interest" additional force. Also that the Court's construction brings confusion into other branches of the tax statute. And see dissenting opinion of Magruder, J. (R. 105).

In *Dobson* v. *Commissioner*, 320 U. S. 489, 88 L. Ed. 179 (1943) this Court said,

> "It is contended that the applicable statutes and regulations properly interpreted forbid the method of calculation followed by the Tax Court. If this were true, the Tax Court's decision would not be 'in accordance with law' and the Court would be empowered to modify or reverse it. Whether it is true is a clear-cut question of law and is for decision by the courts. . . ." 320 U. S. p. ; 88 L. Ed. p. 182.

The case related to whether certain transactions in separate years, relating to the same subject matter, should be treated for tax accounting purposes as a single transaction or as a series of separate transactions. This Court held that the Tax Court's determination of this issue should stand because the issue presented essentially a question of fact. The decision accords new emphasis to the finality to which decisions of questions of fact by the Tax Court are entitled when supported by substantial evidence. But, as the above quotation shows, it does not impart immunity to errors of law committed by the Tax Court.

What constitutes sound accounting practice is an issue of fact. There is little law about accounting. If a man promises to pay money based on certain operating results, to be ascertained in accordance with sound accounting practice, the issue of how much is due from him would be almost completely a question of fact. But "indebtedness" and "interest" are very strongly legal conceptions. There is a great deal of law about them and it is far more likely that Congress used these words in the deduction section with reference to the common understanding of their meaning—than that it used them in some new and strange sense,[10] peculiarly related to taxation, which only "an administrative body having

[10] Cf. *Commissioner* v. *Raphael*, 133 F. 2d 442, 445 (C.C.A. 9th, 1943).

special competence to deal with the subject matter would have the insight to interpret and apply."[11]

In the present case, practically all material facts are stipulated. There is a clear, complete and unambiguous instrument to be analyzed and a direct and categorical provision of the statute to be construed and applied to it. There is no evidence or suggestion of the notes being a sham, or temporary expedient or instrumentality for accomplishing an entirely distinct purpose. Hence, no substantial issue of fact is presented upon which a finding supported by evidence would be final.[11] The only dispute of fact which the Tax Court opinion even contemplates is the issue made by the Tax Court with respect to "intent," which upon analysis is nothing but an improper concern with a question of "motive."

The meaning of the words in the deduction section; whether the deduction section is absolute or subject to the reading in of implied exceptions; whether the meaning of the section may be varied by applying a distinction between "loans" and "Capital investments"; whether the notes do or do not evidence debts; whether or not the annual sums agreed to be paid thereon to service the debts are payments of the type which the law knows as interest; whether a complete and unambiguous written instrument may be distorted from its true intendment by extrinsic evidence and discussions of "motive"; whether a confusion of "intent" and "motive" is erroneous and prejudicial; whether it may be held that every feature of an instrument is a permissible feature of a debt and yet that all features together make the instrument not a debt, notwithstanding that the central feature is an unqualified promise to pay a fixed sum at a fixed maturity; whether a purported statutory construction, implied in a decision, amounts practically to judicial legislation; whether a particular application of a statute would violate established canons of construction; all these are questions of law and not of fact and on each one of these the Tax Court (and the Cir-

[11] See dissenting opinion of Magruder, J. (R. 105-106).

cuit Court of Appeals) arrived at an erroneous conclusion or it could not have reached the result it did.

It follows that the use made of the *Dobson* case is in conflict with that decision and, as pointed out by the dissenting Judge [12] is a use which should not be made of it until explicitly authorized by this Court.

III. THE QUESTIONS OF LAW PRESENTED ARE OF IMPORTANCE AND SHOULD BE DECIDED BY THIS COURT.

A. *The issues are important in the administration of the revenue laws.*

Certiorari has often been granted for this reason and often in cases which were certainly of no wider interest or importance than the present case. There are now a large number of decisions of the Circuit Courts of Appeals and other Courts endeavoring to deal with the distinctions between indebtedness and stock in so-called borderline cases (many of which are made borderline cases only by the Courts' own gratuitous assumptions with respect to what rule they are administering). In the entire case literature upon this subject we have found no direct word from this Court.

The use of loose criteria, the straying away from respectful adherence to the text of the statutes, the assumption that unambiguous documents may be controlled by extrinsic evidence, the blurring of "intent" with "motive," the too wide assumption of latitude in searches for "substance" to replace "form," have resulted in a body of decisions which are difficult to reconcile and which afford no firm foundation for future conduct, either of taxpayers or of the Commissioner of Internal Revenue. They range from one extreme comprising a group of cases decided in favor of taxpayers, the soundness of some of which decisions [13] we frankly question, to extreme

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[12] (R. 106).

[13] e.g. *Commissioner* v. *Proctor Shop*, 82 F. 2d 792 (C.C.A. 9th, 1936)

Helvering v. *Richmond F. & P. R. Co.*, 90 F. 2d 971, (C.C.A. 4th, 1937)

cases in favor of the Commissioner as exemplified in the present case.[14]

The rule to be applied in these cases ought to be settled and its boundaries defined by this Court. It is moreover necessary, if the case of *Dobson* v. *Commissioner* is not to create confusion in the law far greater than the compass of any addition which it has made to the law, that this Court pass upon its applicability in cases like the present, where the extent of genuine factual issues is almost zero and questions of law are presented by the handful.

B. *The issues are important to the security of commercial transactions.*

When after careful consideration the decision to issue these notes in exchange for stock was reached in the year 1939, the conclusion that interest thereon would be deductible was clearly warranted by the express language of the statute, which has not since changed, and by every decision which the industry of counsel could unearth.

It is natural and unavoidable that under pressures of taxation, people will seek to arrange their affairs to keep its incidence upon them at a minimum. Indeed, the complexity of tax laws, and the variety of circumstances under which they now impinge upon every move a man can make with respect to property have actually resulted in exalting the prediction of tax consequences above the exercise of normal good

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Guaranty Savings & Loan Co., 14 BTA 72
Palmer, Stacy-Merrill, Inc., 39 BTA 636, Affmd. 111 F. 2d 809
Diamond Calk Horse Shoe Co. v. *United States*, D.C.D.Minn. 7/20/40, CCH Par. 9641, Appeal Dismissed on Stipulation 116 F. 2d 284
Meridian and Thirteenth Realty Co., 44 BTA 865
See Also *H. R. Demilt Co.*, 7 BTA 7

[14] It may also be of interest to examine *John Kelley Co.*, 1 T.C. 457; reversed in *Commissioner* v. *John Kelley Co.*, 146 F. 2d 466, (C.C.A. 7th, 1944), with respect to which we understand certiorari is being sought.

judgment as to business arrangements or dispositions to be made with respect to property.

No one concerned with corporate finance or with the settlement of the affairs of an individual can today give primary consideration to desired economic objectives. It is necessary to consider first what may be done without the incurring of tax consequences so heavy as to prohibit the pursuit of those objectives. If, upon top of this, one is obliged to wade through a welter of conflicting enunciations of principles by the various lower federal courts, without clear guidance from this Court, transactions are handicapped to a preposterous degree.

There is nothing to distinguish the present case from the Second Circuit case of *O.P.P. Holding Company*,[15] in real substance, except that the Talbot Mills notes bear a variable rate of interest. And yet, this provision for a variable rate of interest is indistinguishable in principle from the variable rate of interest provided for in the General-Mortgage Income 4½% Bonds of the Erie Railroad Company, issued in reorganization under court supervision, an excerpt from which is appended to this brief as Exhibit A. If the Erie Bond interest is not deductible in computing the taxable income of that Company, we think it may with complete safety be assumed that the consequences upon the revenue available for the Erie stock will obliterate assumptions legitimately made in formulating the terms of the Erie reorganization.

It is our contention that the decisions below display upon their face that they are not founded upon the words of the tax statute but upon judicial notions of what would be a wise incidence of legislative policy upon each particular case as it arises. The uncertainties to be injected into the guiding of important matters in the course of ordinary commercial affairs, by allowing such a judicial approach to stand uncorrected, calls, we submit, for the interposition of this Court.

C. *The issues presented are of importance with respect to the judicial process itself.*

Many a decision, deemed erroneous by unsuccessful

[15] 76 F. 2d 11 (C.C.A. 2nd, 1935)

counsel, has been none the worse for that and has presented no issue of public importance with respect to the judicial technique. This case, we submit, stands upon another footing.

It seems impossible, reading the majority decision in the Circuit Court of Appeals and the Tax Court decision, to avoid the conclusion that these tribunals in effect legislated against the Petitioner because of the belief that the Petitioner had substituted notes for stock to obtain a tax benefit to it.[16] Yet the Petitioner was thoroughly entitled to seek this result, in reliance upon what was said by this Court in *Bullen* v. *Wisconsin* and it is common knowledge that everyone does it whenever feasible.

The Petitioner went about the matter openly, issued notes that were absolutely genuine and vitiated by no secret underlying arrangement, incurred the heavy responsibility of facing a problem of refinancing at maturity and incurred a fixed obligation to pay at least [redacted] per cent interest in any event and an equally absolute obligation to pay as much more as might be determined by application of the interest formula. No issue of sham, temporary device or the like was or could have been presented.

Nevertheless, using judicial techniques which are appropriate and permissible only where substantial issues of fact of the type last-mentioned are presented, the Courts in effect denied the reality of what the Petitioner had really done. In so doing they viewed as material for that purpose the "tax motive," the fact that noteholders were also stockholders, the fact that there was but few stockholders, the fact that these persons were related by blood or marriage and other like circumstances having nothing to do with the meaning and legal intendment of the Petitioner's [redacted] contract.

Is there one law for corporations with 15 stockholders and another law for corporations with 15,000 stockholders?

Is there one law for corporations whose security holders

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[16] See, similarly, *Commissioner* v. *John Kelley Company*, 146 F. 2d 466, 468 towards the end of the page.

are related and another law for corporations whose security holders are unrelated?

Is there one law for the Erie Railroad and another law for the Talbot Mills?

May the emphatic words of Congress be disregarded and policies legislated in their stead by the Courts?

Are citizens to be told by this Court that they may rearrange their affairs with a view to the incidence of taxation and told by a Judge of the Circuit Court that if they do he will find a way around it?

May a case with stipulated facts, with an unambiguous instrument to construe, and a statute to be interpreted and applied, be decided on the basis of the sort of extrinsic considerations which would properly be pertinent only to cases of alleged sham, temporary expedients, devices for unrelated ends or manifest ambiguities?

May Tax Court decisions in a case, involving fundamentally only issues of law, find shelter under the *Dobson* case by stretching the conception of what is "fact" to cover them?

Was not the Petitioner clearly entitled to a judgment operating upon principles of law as exemplified by the dissenting opinion in the Circuit Court of Appeals?

And are not these issues of sufficient general importance to receive the attention of this Court?

Respectfully submitted,

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TALBOT MILLS.

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Of Counsel.

EXHIBIT A

Excerpt from Erie Railroad Company 4½% Income Bond Series A, due January 1, 2015

". . . to pay interest on said sum from the date hereof until

the payment of said principal sum at the rate of four and one-half per cent. (4½%) per annum, beginning April 1, 1942, on April 1 of each year thereafter, to and including April 1, 2014, and on January 1, 2015 (in each instance through the December 31 next preceding), and to pay an amount equal to interest at such rate from January 1, 1940, to the date hereof, *but, except as otherwise provided herein or in the Indenture hereinafter mentioned, only if and to the extent that the amounts applicable thereto under the provisions of the Indenture are sufficient to make such interest payments* and until the maturity of this Bond only upon presentation and surrender of the appropriate coupons as provided in the Indenture. *Unpaid interest will accumulate* [1] *to an amount not exceeding prior to maturity (exclusive of interest earned as provided in the Indenture but unpaid) 13½% of the principal hereof at any one time and such accumulated interest will be payable thereafter if earned as provided in the Indenture or, in any event, at the maturity of this Bond whether by declaration or otherwise.*" (Italics supplied)

Provisions of Article 5 of the mortgage indenture, too lengthy to quote herein, deal with the determination of "available net income," provide for numerous deductions therefrom for various purposes and state that "any then remaining available net income shall be applied to the payment of interest on the bonds." Other lengthy provisions may be summarized as providing that interest for each year shall accrue and become owing as a debt only if and to the extent that the amounts applicable to the payment thereof, under the provisions just mentioned above, shall suffice therefor. The provisions are elaborate and include other restrictions or qualifications of the obligation.

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[1] It will be noted that only three years' unearned interest becomes unqualifiedly payable out of 74 years that the bond has to run to maturity.